THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 281 **September 1996**

Phony Wealth

"Along with criticism of the banks' failure to lend in the 1930s went another charge that cut deeper: Banks had lent too much in the 1920s, and this overextension of credit and the resulting speculation were the root cause of the Great Depression."

Citibank 1812-1970
Harold van Cleveland and Thomas Huertas, 1985

Hints of stronger U.S. economic growth again have spooked the global speculative crowd, triggering another abrupt reversal from bullish to bearish sentiment on Wall Street. Accordingly, the recovery of stock and bond prices take took hold in early August now is overshadowed by renewed fears of a Federal Reserve tightening.

While Wall Street remains obsessed with the near-term prospects for growth, inflation and the Fed, we continue to focus on long-term structural trends, which we fear spell imminent death for the great secular bull market that began in the early 1980s.

In this issue, we examine some of the myths that have sustained the speculative frenzy in the global financial markets. In particular, we cast a skeptical eye on the widely held assumptions that the trend towards ever-lower long-term interest rates and continuously accelerating corporate earnings growth can be prolonged indefinitely.

In truth, these two powerful trends have been interrelated for some time. As we explained in our last letter, much of the impressive earnings performance of U.S. companies in the 1990s can be traced to the sharp drop in both long-term and short-term interest rates engineered by the Fed's easy money policies. Lower rates not only reduce corporate debt-service costs, they also inflate the valuations placed on corporate profits in the stock market.

By nature, this trend cannot be prolonged indefinitely. Indeed, we would argue that U.S. interest rates already are at artificially low levels, pushed and held down by Fed looseness, and by the foreign central banks and global yield-curve speculators who have come to dominate the U.S. Treasury market.

This support now is threatened both by the renewed fears of Fed tightening, and by the mounting financial woes of Asia's Tiger countries. Purchases of Treasuries by foreign central banks, which slowed to a trickle earlier this year, rose to a stupendous $23.5 billion in the final week of August. Where would U.S. bond yields and the dollar be without this colossal and exotic support?

The danger should be obvious. Without massive official intervention, the dollar would be extremely vulnerable to any reversal in the bullish speculation that now constitutes its main source of support. Already, the dollar bulls are puzzled by the greenback's failure to rise, despite the wide interest-rate differentials between the United States, on the one hand, and Europe and Japan on the other.

The answer, of course, is that Fed policy still is not nearly tight enough to compensate for the downward pull on the dollar exerted by the chronic U.S. current-account deficit. It is this unsustainable imbalance, more than any other, that threatens to bring down the curtain on the global bull market. Any significant declines in stock and bond prices would make short work of the U.S. economic expansion, by deflating the massive pyramid of paper wealth that is its main underpinning.

SPECULATION FROM HAND TO MOUTH

Since early this year, the great, striking constant in the U.S. financial markets has been the abruptness of the repeated reversals in prevailing perceptions and expectations. As the great bull year of 1995 drew to a close, and the focus turned to prospects for 1996, a consensus developed that the U.S. economy would slow down, causing the boiling stock market to cool, or even triggering a correction. The recommendations coming out of Wall Street favored investing in Asia, both in Japan and the Tiger countries.

The big surprise of early 1996 was that U.S. equities continued their strong advance. With apparently solid corporate earnings reports, a heated market for mergers, acquisitions and IPOs, and a record flood of money pouring into stock mutual funds, the stage seemed set for a repeat of 1995.

By late February and early March, however, this financial idyll was jolted by very strong job numbers, surging oil and commodity prices, and a multitude of better-than-expected economic reports, plainly signalling a strengthening pace of economic growth. In no time, expectations of slower growth and easier money gave way to apprehension about fearsome economic overheating and intensifying inflation, implying rate hikes by the Federal Reserve.

From its all-time high on May 22 of 5,778, to its trough on July 23 of 5,346, the Dow lost 432 points, or 7.5% of its value. The Nasdaq Composite Index fared even worse, falling 16% from its June high of 1,254. The bull market seemed on the ropes.

But mid-July saw yet another about face of perceptions and markets. As the economic data turned rather mixed between strong and weak, Wall Street switched back to its preferred bullish forecast: moderate economic growth and subdued inflation ahead. Rate hike worries promptly evaporated. All of this sufficed to trigger the biggest four-day drop in bond yields since late 1987.

Then, in mid-August, gloom again descended abruptly on the markets when the Commerce Department reported a greater than expected 1.6% jump in July durable-goods orders. This unexpected show of economic strength was enough to send bond prices down again, lifting the yield on the benchmark 30-year Treasury bond back to 7%.

But, while the mid-July bond rally strongly buoyed the stock market, the new rise in yields initially left it unperturbed. The Dow and the S&P 500 hovered only slightly below their former peaks until late in August, when additional strong economic reports pushed stock prices down. The broader market, by contrast, benefited relatively little from the July rally. The Nasdaq and the Russell 2000 indexes – the broadest measures for small-cap stocks – remain over 8% below their earlier highs. Aggressive stock funds have lost between 25-30% of their value. And for the high-technology stocks, it's been a real bloodbath.

In hindsight, the bulls now proclaim the July sell-off a healthy correction that has rid the market of speculative excesses in small cap stocks. With renewed emphasis on the larger blue chips, they contend, the market can return to its previous, ever-rising ways – as long as the rebound in economic growth doesn't trigger a round of tightening by the Federal Reserve.

What strikes us is both the frequency and the vehemence of these shifts in moods and markets. This has no semblance to genuine investing. More than ever, both the U.S. bond and stock markets have become arenas for the most extreme forms of short-term speculation, where players simply position for and react to each piece of economic data as it is released.

In desperate search of quick profits, speculation shifts easily between opposite directions. Players, all bunched together on one side of the boat, quickly scurry to the other side. Essentially, they have to take their profits as quickly as possible to stay ahead of the crowd. This, in turn, foreshadows the next counter movement. It's a form of speculation that literally lives from hand to mouth.

THE BIG LEVER THAT HAS SPENT ITSELF

What are we to make of this unusual volatility? We think it has a deeper cause that bodes ill for the markets. The 15-year global bull market in equities and bonds is drawing to a close because the key force that has driven stock and bond prices steadily higher has largely, if not completely, spent itself.

This all-important lever was the long decline in interest rates that began in the early 1980s. The strength of this influence varied from country to country, being strongest in the high inflation countries of the 1970s, among them the United States, where short- and long-term rates plummeted from a range of 15-20% to the present 5.5-7%.

The bullish leveraging effect of such a prolonged plunge in rates on bond prices is self-evident. What is less understood is that declining rates also have a double-whammy leveraging effect on stock prices. One stems from the direct impact of lower rates on corporate debt service, the other is an indirect function of the role of long-term interest rates in setting market capitalization. In other words, falling interest rates raise corporate earnings, and at the same time, raise the market's valuation of those earnings.

As we explained in the last letter, the U.S. corporate profits boom of the 1990s owed everything to a huge windfall gain from the collapse in interest rates. Plunging interest rates worked with equal vengeance toward sharply higher capitalization of profits. This, of course, is a non-recurrent event.

But for the time being, the markets are infatuated with two arguments for why the great bull market can continue for the indefinite future. One popular contention is that U.S. longer-term interest rates, in fact, do have room to fall further. Supposedly, only misplaced inflation fears are holding them up. As to equities, it is widely held that the corporate profits boom of the past few years will last forever, albeit with some moderation.

On both counts, we must vehemently disagree. Fed statistics make it abundantly clear the sharp decline in U.S. long-term interest rates since early 1995 has been entirely the work of two extraordinary groups: foreign central banks and leveraged speculators. The genuine investor has been missing completely.

We will discuss these two camps in more detail later in this letter. But let us summarize here by saying that in light of their abnormally high bond purchases, current levels of U.S. long-term interest rates are artificially low. There is little or no bang left in the interest-rate game. The long downtrend is over. One result is that ever more frantic attempts to exploit the smallest ups and downs in the bond market breed ever more frantic fluctuations.

For the U.S. stock market, we think the predictable spoil sport for the bulls will be disappointing profits. As explained in the last letter, profit growth since early last year has fallen sharply. But this downtrend has been obscured through various tricks, jointly applied by Wall Street and the corporations. The chief deception is to slash preannounced profit forecasts, so that actual profits then appear "better than expected" by comparison.

According to the Wall Street mantra, the U.S. corporate profits boom has had a solid source in the great efficiency gains brought by widespread downsizing and restructuring. But the ugly truth is that there absolutely is no evidence for this boast in either micro or macroeconomic statistics. Even in the face of strong economic growth, overall productivity gains have been hovering around a dismal 1% annual rate.

PAPER PROSPERITY VERSUS REAL PROSPERITY

On the surface, the U.S. economy looks healthier than it has been for years. Inflation is at its lowest ebb since the 1960s. Strong U.S. job growth is the envy of the world. The budget deficit, as a share of GDP, is lower than in Europe or Japan, and wealth creation is running at an all-time high. Yet under the surface, colossal imbalances and maladjustments have been building in the economy and its financial system.

The basic root of these imbalances is the exponential growth of money and credit flows despite a very poor supply of savings. The most conspicuous manifestation of this trend is a virtual explosion of financial assets (and

the value of those securities) in proportion to tangible assets. This suggests extensive debt creation for other than productive purposes. The actual gain in real wealth, broadly defined and measured as net investment minus the increase in foreign indebtedness, is abysmal by comparison.

While stock prices have been flying high and away, the United States has had the lowest rate of net investment – and, not coincidentally, the lowest rate of long-term productivity growth – among the industrial countries. This has been reflected in a persistent decline in real per-capita wages.

The dismal trends in real capital formation, productivity and real wage growth have been obfuscated by the prolonged financial boom, which has invoked an unprecedented expansion in financial wealth. Because it is conventionally associated with declining inflation, this surge is viewed as a sign of extraordinary economic and financial health.

Few people seem to remember that this same (mis)perception also prevailed in the late 1920s in the United States and in the late 1980s in Japan – in each case, shortly before booming stock markets abruptly collapsed. With the benefit of hindsight, the Japanese have labeled their financial mania "the bubble economy."

In the consensus view, as orchestrated by Wall Street, this truly is the best of all possible worlds for America: low inflation, strong job growth and overflowing prosperity. Observing things principally through the lens of good old-fashioned economics, we must vehemently disagree. This prolonged financial boom, widely hailed as the great mainspring of wealth creation, in reality is the road to long-run impoverishment, because it fosters prodigious consumption and speculation at the expense of real capital accumulation.

In the same vein, the unprecedented proliferation of financial paper and paper values is no part of real prosperity. More nearly the opposite is true. To quote Keynes on this truly crucial point: "It is investment, i.e. the increased production of material wealth in the shape of capital goods, which alone increases national wealth, and can alone in the long run bring down the natural rate of interest."

We agree that America has by far the most efficient credit machine in the world. It is the pride of Wall Street. But unfortunately, this overly efficient credit machine is primarily geared toward bolstering consumption and speculation. That alone is the source of Wall Street's growth and glory. Financing just the minimal incremental growth in real investment would be much too small an undertaking to keep brokers and investment bankers busy and profitable.

To be sure, the paper deluge brought about by this kind of lending does become private wealth to lenders and investors. But viewed from the perspective of the economy as a whole, all this paper is phony wealth, built on nothing but asset-price inflation and borrowing from future generations. Actually, by absorbing savings, the debt explosion fuels capital consumption at the expense of future growth. Thus our contention: the road to impoverishment is lined with paper wealth.

Since the present U.S. financial boom has occurred in the face of a collapsing personal savings rate, its true cause also should be self-evident. Rising asset values have been stoked by persistent, ultra-loose money fueling unprecedented financial leveraging. This is rampant inflation, but it has shifted from Main Street to Wall Street – the typical "bubble" phenomenon.

In the last analysis, the inflated U.S. credit and money flows generated through this process largely have gone to finance three types of rapidly rising expenditures: consumption, debt service and purchases of bonds and stocks. Even business borrowing has been overwhelmingly directed toward the financial markets, accommodating mergers, acquisitions and stock buybacks. By and large, there has been extremely little productive credit growth.

As regards the real economy, this asset bubble is marked by two complementary imbalances: a consumer borrowing binge, and a large, chronic current-account deficit.

DISINFLATION BORROWED FROM ABROAD

It is customary to pooh-pooh the significance of the U.S. external deficit with the argument that it constitutes just a fraction of U.S. GDP. But looking at the cumulative total deficit since the early 1980s, it becomes apparent that it has been of crucial importance to the health of the U.S. economy, and particularly vital to the well being of the U.S. consumer. In a word, the deficit has allowed America persistently to live well beyond its means, without incurring the unpleasant costs of consumer- and producer-price inflation.

By containing economic growth and conventional price inflation, the current-account deficit has provided the leeway for the Fed's chronic monetary looseness. This, in turn, has prevented any significant adjustment in the external balance, and kept the consumer-borrowing binge and the financial bull market in full swing.

The key point to see is that the perennial import surplus resulting from these credit excesses is a resource transfer that enlarges the available supply of goods and services – over and above U.S. current domestic output – by a corresponding amount.

To understand the role of imports in suppressing U.S. consumer-price inflation, we think it is crucial to view it in perspective. In 1994 and 1995, this transfer of foreign resources amounted to $151 billion and $153 billion, respectively, compared to nominal domestic output growth of $381 billion and $316 billion. Between 1982 and 1995, the United States enjoyed a cumulative resource transfer – as measured by the current-account deficit – of about $1.4 trillion, as against overall domestic output growth of about $4 trillion.

Altogether, these figures denote a massive transfer of foreign resources equal to 2.7% of U.S. GDP per year, implying that domestic spending has been in excess of current production by that same percentage. Paradoxically, by far the biggest supply-side effect of Reaganomics consisted of this snowballing resource transfer from abroad through the trade- and current-account deficits.

Yet remarkably little thought, if any, has been given to the ramifications of this supplementary inflow of foreign goods and services for the U.S. economy. Given the extraordinary magnitude of this resource transfer, the implied effects are sizable. In fact, they can be seen in two areas: lower U.S. inflation, and higher U.S. living standards.

As already mentioned, a basic facet of any merchandise deficit is that it adds to the supply of goods in the country concerned. Relative to unchanged money incomes, there are more goods available, and this extra supply inherently subdues inflation. Equally inevitably, the additional goods lead to a complimentary rise in living standards. In that context, the U.S. deficits can be seen for what they are: the most gigantic free lunch in history.

Paradoxically, through these two major effects, the prodigious U.S. trade imbalance for years has been creating a specious appearance of wonderful prosperity and low inflation. Comparing the big supply effects of the trade deficit with the poor U.S. productivity record suggests that the U.S. prosperity and stability of the 1980s and 1990s literally has been borrowed from abroad.

In the absence of this massive resource transfer, the United States long ago would have experienced rampant inflation – not the current pleasing variety, which pushes up asset prices, but the ugly type that ratchets up the prices of goods and services and compels central banks to tighten monetary policy. Needless to say, such a development would have precluded the current bull market on Wall Street.

AN UNMISTAKABLE BUBBLE

Well, what's wrong with this scenario? In short, the boom literally is living on borrowed time. The money deluge engulfing the U.S. financial markets largely has accrued from exponential borrowing and leveraging, combined with a mass movement out of liquid assets and into securities. Looking at personal savings – the normal source of investment funds – these amounted in 1995 to $240 billion, barely higher than 1985's $235 billion. Genuine savings have become mere pocket money for the markets.

Dealer call loans were the main leverage vehicle leading up to the 1929 crash. Today, by contrast, a vast array of leverage devices are available, both for bonds and stocks. But the paramount lever is the global repo market. Thanks to this mechanism – and to the steep yield curves firmly established by the central banks – bond-market leverage is rampant and, in actual practice, virtually unlimited. In other words, bond markets, and the U.S. bond market in particular, have thoroughly decoupled from the flow of savings.

Financial leveraging means using a lever for the purchase of an asset. The lever is credit. The biggest single source of the money fueling the U.S. stock market boom has been heavy corporate borrowing to finance mergers, acquisitions and stock buybacks. These totals have run in recent years at an annual rate of several hundreds of billions of dollars. Stock buybacks alone amounted to nearly $100 billion in 1995, and are setting records this year.

Individuals, in turn, have leveraged their stock purchases through soaring margin debt, and, indirectly, by allowing their outstanding credit-card balances and other debts to grow. All this, in short, comes clearly and definitively under the heading "bubble."

Yet most of the speculative flows supporting the markets elude precise measurement because the speculators involved make wide use of off-shore addresses and off-shore money. When a U.S. hedge fund, domiciled in the Bahamas, borrows cheap yen to finance a holding of U.S. Treasury bonds with a tiny down payment, these transactions appear in the U.S. balance-of-payments statistics as rock-solid foreign investment.

Searching for some clue to the growth of cross-border speculation, we have pounced upon the U.S. external capital account, which shows an explosive expansion of flows during the last few years.

The figures are nothing short of astonishing. In 1995, the United States had on top of its huge current-account deficit of $153 billion further huge capital outflows of $308 billion. And yet currency experts and traders round the world have wondered why the dollar is persistently weak. The reason for their confusion is obvious: They look myopically at nothing but short-term interest rate differentials, ignoring the disastrous U.S. balance-of-payments gap.

Moreover, we think these capital-flow figures are quite a good proxy measurement of the rampant growth in international financial speculation in the past two or three years. American speculators have been flooding global financial markets with money, adding up to many hundreds of billions of dollars. But, given the huge U.S. current-account deficit, it would be accurate to say it is all borrowed money. In the same vein, we think much of the reported surge in foreign purchases of U.S. securities can be traced to the global carry trade, much of it on the accounts of U.S. speculators.

The figure also confirm that domestic investors have deserted the Treasury market, leaving it in the hands of a strange crowd of leveraged speculators and foreign central banks. During 1995, U.S. private institutions and investors were net sellers of $42 billion in Treasuries, despite nearly $80 billion in purchases by two U.S. groups: broker dealers and subsidiaries of foreign banks.

DOUBLE JEOPARDY

We still are struck by the intricate question: Why should this financial boom ever abort, as long as the Fed continues to keep money easy? Indeed, there is a widespread view that the orgy has a long way to go, simply because the current moderate pace of economic growth and the associated moderate rate of consumer-price inflation will keep monetary tightening at bay. In this view, only tight money can prick a financial bubble or drive an economy into recession.

The German-Austrian economic school always has held an entirely different view. The principle cause of recessions and crashing markets, in this view, always are the debt excesses, imbalances and maladjustments that result from a prolonged period of overly loose money. The true culprit in any crash is the prior monetary looseness, not the later monetary tightening. By restraining excesses, tighter money prevents the worse from following.

Inherent in this notion is the presumption that, if not stopped by and tighter money, speculative booms and bubbles ultimately will burst of their own accord, but even more violently. It was this concern, by the way, that induced the Bank of Japan to pierce the Japanese asset bubble in 1989 and early 1990 with a series of interest rate hikes, even though consumer- and producer-price inflation was near zero.

U.S. Capital Account Transactions

In Billions of Dollars

	1991	1992	1993	1994	1995	1996 QI
U.S. Capital Outflows	57.9	65.9	184.9	150.7	307.9	55.7
Direct Investment	31.3	42.6	72.6	54.5	95.5	26.8
Foreign Securities	45.7	46.4	141.8	60.3	99.0	33.5
Non-bank Claims	11.1	0.0	1.6	32.9	34.2	NA
Bank Claims	0.6	20.9	30.0	8.2	69.1	4.5
U.S. Capital Inflows	94.2	153.8	248.5	285.4	424.5	98.8
Direct Investment	22.1	17.6	41.1	49.8	60.2	29.5
U.S. Securities	71.3	107.2	176.0	131.5	304.4	99.2
Private	53.9	66.7	103.9	91.2	194.6	47.6
Central Banks	17.4	40.5	72.1	40.3	109.8	51.6

Source: U.S. Commerce Department

FEELING LIQUID VERSUS BEING LIQUID

But to return to our question: Why should a runaway boom and financial bubble burst of its own accord, if monetary policy continues to hold the spigots open? In short, because the debt and leveraging excesses inherent in any speculative mania essentially undercut the liquidity of the economy and its financial system. This progressive impairment of overall liquidity is well under way in the United States. The warnings signs can be seen all over, in the form of soaring debt ratios and plunging liquidity ratios.

These ratios uniformly bear witness to rapidly eroding liquidity. As such, they contrast dramatically with the prevailing notion that the buoyant financial markets must reflect growing excess liquidity in the economy. This appears axiomatic to some analysts, given their lack of an alternative explanation for the bullish frenzy.

For the individual, liquidity is largely a subjective concept. The investor who has exchanged a large part of his bank deposits for stocks effectively has reduced his liquidity, because the prices of marketable stocks are subject to fluctuations. Yet most probably, he fails to see it that way, in the belief that his stock holdings are easy to sell and therefore highly liquid, at least, as long as stock prices are rising. He has been repeatedly reassured that a simple phone call is all that is required to convert his holdings into cash.

But if many investors decide to swap cash for stocks, the resulting stampede out of liquid assets and into illiquid securities essentially reduces overall liquidity, as the security holdings of the investing community grow out of proportion to its money holdings. In the face of booming markets, the demand for money tends to collapse.

This is precisely what has happened in the past few years. The measurable, objective effect of any asset bubble is declining liquidity, yet participants tend to take rising asset prices as a hallmark of excessive liquidity.

But the demand for money cannot decline forever. There inevitably comes a point where investors begin to deem it desirable, if not necessary, to preserve their existing liquidity by buying fewer securities, or even to expand liquidity by selling them. That ultimately is what ends any speculative bubble, with or without monetary tightening.

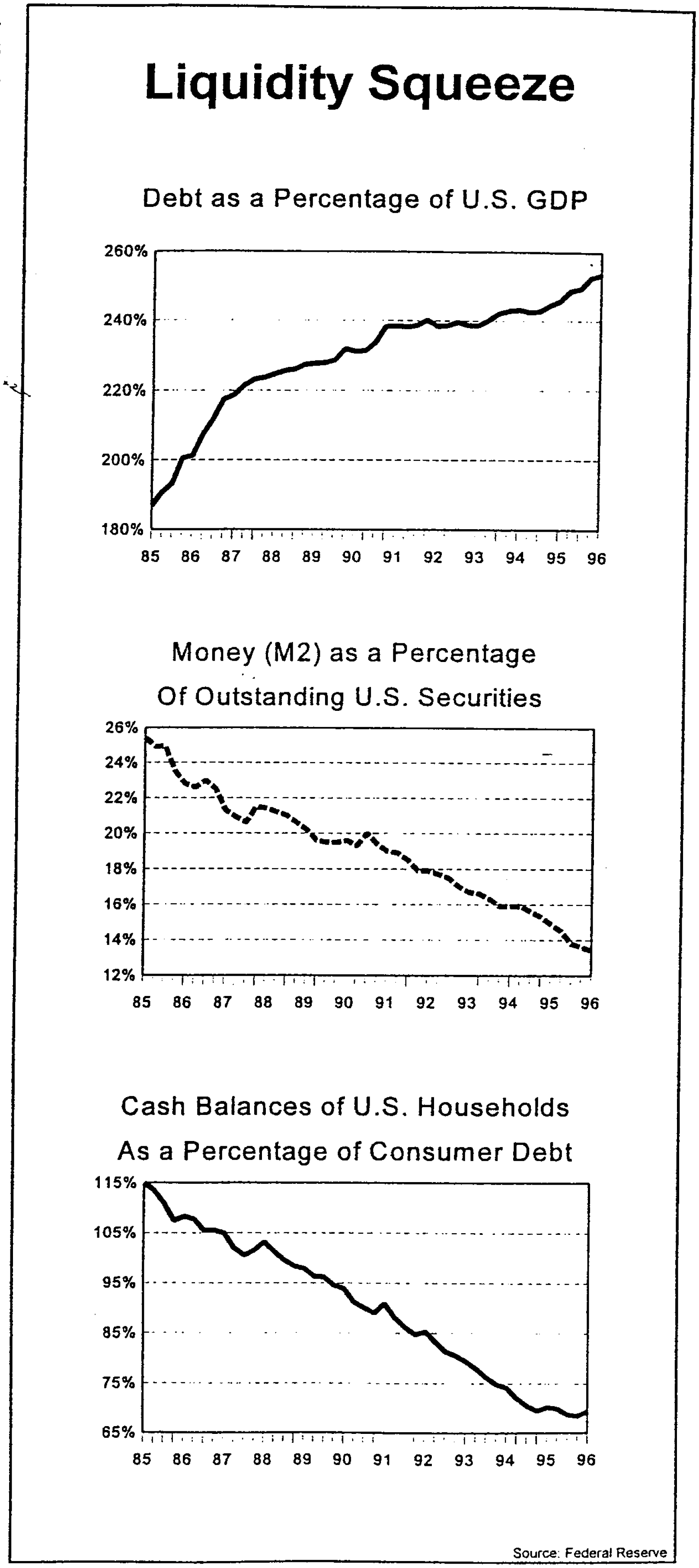
In this respect, too, the handwriting of a rising liquidity preference is clearly on the wall. Having depleted their time and savings deposits from 1991 to 1994, private U.S. households since early 1995 again have been accumulating such deposits and money-fund shares.

As the markets languish and expected capital gains fail to materialize, speculators increasingly capitulate and sell. Over time, there is bound to develop a scramble for liquidity by overextended investors. The snag is that selling securities does not create liquidity. For every seller there must be a buyer who surrenders an equal amount of cash.

If, on balance, there is selling pressure, security prices decline, even though the money stock is unchanged. In this way, the very effort to increase liquidity actually destroys it by depressing the markets.

The progressive erosion of liquidity is one jeopardy for the U.S. economy and financial markets. The large, chronic current-account deficit and the associated growing dependence on foreign capital inflows is another. In any other country, such a perennial payments gap long ago would have triggered a currency collapse, forcing the central bank to drastically tighten monetary policy, regardless of the economic and financial consequences.

In the case of the United States, this balance-of-payments constraint has been eliminated by foreign central banks. To suppress an undesired rise of their currencies against the dollar, they have been gobbling up any dollars unwanted by private investors. In doing so, they effectively help perpetuate the Fed's easy policy stance, which creates the excess dollars in the first place.



THE BEARISH CASE FOR BONDS

When we speak of raging speculation and financial leveraging as sources for the financial boom, the bond markets in general and the U.S. bond market in particular are foremost in our minds.

Today, it is standard theory that long-term interest rates are simply a function of current or expected rates of consumer- and producer-price inflation. Because it is oblivious to supply and demand factors, such as available savings and credit demand, this really is an unbelievably primitive concept. But it's the rule by which the markets play.

Globally, the outlook for consumer- and producer-price inflation has dramatically improved in recent years. According to conventional thinking, then, we should be bullish on long-term bonds.

Yet we are not. What prevents us is our realization that the global bond markets are grossly inflated by rampant, leveraged speculation, driven by generally steep yield curves. This applies, to varying degrees, to all bond markets. In Germany, for example, almost 90% of total net purchases of domestic bonds this year have come from banks and foreigners. Retail demand has been virtually zero.

Still, Wall Street undoubtedly is the world champion of geared speculation. In the United States, generally speaking, savings are in the shortest supply and speculative finance is in the most abundant supply. As we explained earlier, the sharp decline in long-term U.S. interest rates during 1995 was almost totally the work of financial leveraging and central banks, Fed and foreign.

TWO OUTLETS FOR MONEY AND CREDIT

While we agree with the optimistic inflation forecasts, we disagree with the view that this improved price performance should be attributed primarily to the unprecedented inflation vigilance of central banks and the financial markets. We also give little credence to a related argument which holds that the growth in the number of elderly pensioners living on fixed incomes has increased the political constituency for tough anti-inflationary policies.

Looking at the lavish money flows that have poured into the financial markets, all this talk about tight money and "disinflation" appears to us absolutely ludicrous. Measured by these flows, money globally is looser today than ever before. What differs is the fact the available money is drawn excessively into the financial markets.

As the Austrian economist Friedrich von Hayek pointed out, there always are two outlets for credit and money: speculation and business. When the pipe for the flow of credit into business becomes partly clogged, the pipe into speculation overflows. Instead of flooding the real economies with liquidity, fueling inflation in the prices of goods, services and tangible assets, loose money floods into the financial markets.

What is suppressing economic growth in the industrial countries is a general slippage into lackluster economic growth, associated with chronic weakness in investment spending. For decades, investment booms, construction booms and soaring budget deficits have been the chief lubricants of consumer and producer-price inflation by shovelling money and credit into the real economies, with high multiplier effects on demand and incomes.

But now the investment channel is leaking heavily, and budget deficits have reached such exorbitant levels that governments are being forced to retrench. The upshot has been sharply diminished leverage of monetary policy on the real economy and ingrained economic sluggishness. Together, both factors have tended to promote low inflation.

There is nothing virtuous or salutary about this trend. In the United States, lower inflation rates literally are borrowed from abroad though the outsized trade deficit. Europe has low inflation more-or-less by default through the corrosive effects of recklessly overblown public-sector spending and deficits on long-term economic growth. When budget deficits are no longer monetized, they tend to suppress inflation by strangling investment.

Inherent in this development is a bullish impact on financial markets. To compensate for the diminished leverage of monetary policy on real economies, central banks are keeping their monetary spigots open as never before. This has had two evident results: hyper-stimulation of the financial markets, and underperforming economies.

The salient point here is that provoking bull markets in financial assets is an easy task. All that is required is for central banks to set up a positive yield curve. Nowadays, this works like putting a lighted match to a powder keg. The global army of speculators will scurry to make hay. But reflating real economies is a much tougher job.

All central banks have just two levers at their disposal to increase potential credit growth – adding to bank reserves and lowering short-term interest rates. Whether and to what extent this translates into actual borrowing and

lending for investment and consumer spending depends entirely on the subsequent response of banks, businesses and consumers. This is not automatically assured. In Japan, rock-bottom interest rates and super-abundant bank reserves have solicited scant credit demand. So far, it's been a textbook case of pushing on a string.

ASIAN TIGERS: THE JAPANESE PATTERN

Like a bolt from the blue, bad news has struck the heretofore high-flying Asian Tiger countries – Malaysia, Thailand and Indonesia, in particular. Their export growth has slowed drastically. Several are running alarming current-account deficits. Some of the Tiger currencies have come under speculative attack. To quote *The Economist*: Some Asian Tigers appear to be picking up nasty Mexican habits.

Correctly, *The Economist* points to a variety of reasons why the troubles of the Tigers differ fundamentally from those of Mexico in the runup to the 1994-95 peso crisis. Most importantly, it stresses that the Tiger current-account deficits reflect an extremely high rate of domestic investment. By contrast, Mexico's soaring current-account deficit reflected lower savings and higher consumption. Still, we do not see any reason for complacency.

In the three years leading up to the peso crisis, Mexico received some $91 billion in net capital inflows. Two-thirds of this money came in the form of portfolio flows – a euphemism for "hot money." While domestic credit skyrocketed, these huge inflows produced a strange mixture of a soaring trade deficit, a strong currency, a booming stock market and plummeting inflation and interest rates. The markets rejoiced at so much economic health.

Actually, what the Asian Tigers are following are not Mexican but Japanese footsteps. As in Japan, a huge balance-of-payment surplus is the central cause of their present economic difficulties. In Japan's case, this flood of money resulted from a huge trade surplus. In the case of the Tigers, it stems from huge surpluses on their capital accounts. Between 1992-95, the region had net annual current-account deficits of $20-27 billion, as against net capital inflows of around $100 billion.

Still, both kinds of money inflows have the same potential effects: Either they raise the exchange rate of the recipient country, eroding its international competitiveness, or they swell the foreign-exchange reserves of that country, intrinsically fueling monetary expansion and inflation.

In the 1980s, Japan's authorities chose the latter alternative. Their single-minded obsession was to fend off an appreciation of the yen. The means they used were low interest rates and persistent, massive dollar purchases. This stoked an unprecedented credit and liquidity binge, the final upshot being Japan's world-famous "bubble economy," with its rocketing land and stock prices and associated overinvestment in industrial plant and equipment. The world stood in awe of Japan's economic miracle, even as the seeds of disaster were sown.

Undeterred by Japan's disastrous experience, the Asian Tigers are pursuing precisely the same policies. With their currencies pegged, formally or informally, to the dollar, their preferred course of action in coping with their huge payments surpluses has been to pile up dollar reserves and hold interest rates as low as possible. The familiar, final upshot: excessive credit and money creation, and many of the symptoms of a bubble economy.

Sterilization – that is, measures to mop up the strong liquidity creation triggered by capital inflows – has been applied, but on a vastly insufficient scale. Apart from Taiwan and Singapore, all of the Tiger countries are living with persistent double-digit money growth that has tended to overheat their economies and financial markets.

As in Japan, raging credit and money expansion has overwhelmingly stoked investment, both in real estate and in plant and equipment. From the standpoint of long-term economic strength, booming investment certainly compares favorably with booming consumption. But taken to extremes, overinvestment is no less hazardous than overconsumption, as Japan dramatically demonstrated. No country ever had better economic fundamentals – super-sized savings and investment ratios, near-zero inflation and a huge export surplus. Yet it took barely three years of excessive monetary looseness, from 1987 to 1989, to devastate Japan's financial system and economic growth.

FIVE CRITICAL OBSERVATIONS

What makes the Asian Tigers so interesting is that they are universally seen as an outstandingly healthy group of countries with the brightest of futures ahead of them. In fact, they may be teetering on the edge of a cliff.

Indeed, it is astonishing how fast the economic situation in some of the Tiger countries has deteriorated in the past few months. Export growth, previously running in the high double-digits, is hurtling toward zero. South Korea, one of the worst cases, ran a trade deficit of $10.3 billion in the first seven months of the year, versus a 1995 deficit of $9.9 billion, and a government projection of no more than a $7 billion deficit for all of 1996. South Korean exports fell 3.1% in the year ending in July, after showing year-over-year growth of 30% in 1995. Even though import growth also is plunging, the net result has been a sharp widening of the region's trade deficit.

We have drawn attention to this situation because of its global implications. The Tiger economies now are an integral part of the U.S. and Japanese financial bubbles. While America has been overinflating consumption, the Tiger countries, like Japan, have been overinflating their industrial base, pouring hundreds of billions of dollars into production facilities for high-tech products that are completely dependent on export markets.

Weighing developments in these countries, five observations come to mind. First, the Tiger group of countries has been the major growth area in the world. Second, its stock markets have been a magnet for aggressive mutual funds. Third, the region plays a crucial role in the global electronics industries. Fourth, economic overheating combined with weak demand in the industrialized world is straining the Tigers' trade balances. Fifth, these widening deficits pose a threat to the dollar because persistent, large-scale dollar buying by the region's central banks has been the U.S. currency's main prop during the 1990s. At times these purchases even have exceeded the Bank of Japan's.

Of these five observations, two are of foremost importance for the markets. One is the threat posed to the dollar by worsening Tiger trade deficits, considering how dependent some of these countries are on capital inflows. Actually, dollar accumulations by foreign central banks came to a halt in April. The other potential blockbuster is the deepening trouble in the Asian electronics industry, which reflects parallel troubles in the U.S. high-tech sector.

THE BUNDESBANK OBLIGES

At long last, the Bundesbank has obliged, cutting its repo rate by an unexpected, "generous" 30 basis points. More than anything else, it probably was the weak dollar that triggered the cut. Applause is uniform, but is most often connected – particularly abroad — with the question: Will it be enough?

Since Europe's economic predicament has its root cause in fiscal excesses, expensive labor costs and rigid labor markets, the safest thing to say is that there will never be enough monetary ease to revive the economies. In any case, rates for business and consumer credit in Germany are tied to the discount rate, which already has been at 2.5% since February. As to the repo rate, it is pivotal for the financing of leveraged bond speculation. The main beneficiaries of a lower repo rate are the banks and brokers, German and international, who play this game with abundance. German business, nonetheless, generally appreciates such cuts in the hope they may weaken the D-mark.

Though even bigger than expected, the Bundesbank's move has proven a flop. The immediate, minimal effects on DM bonds and the currency lasted less than 24 hours. Dollar weakness is firmly established once again. Adding to DM strength are newly growing doubts that EMU will take place on schedule, if at all.

EMU tensions are surfacing again because persistent sluggish economic growth is defeating government programs to trim budget deficits to no more than 3% of GDP, as stipulated in the Maastricht Treaty. This happens to be bungling the popular intra-European convergence play, which capitalized on the ability to finance holdings of high-yielding European bonds with borrowed cheap short-term DM.

It was a highly rewarding game, but all speculative plays are bound to end sooner or later with profit taking, which largely undoes their prior effects. That's the inevitable fate of bubbles. Any unwinding of the Euro

convergence play essentially must cause new currency turmoil in Europe, weakening the currencies and bond markets of the peripheral countries again, while strengthening the DM.

The definite decision on whether or not to implement EMU on January 1, 1999 is due in mid-1998. Until then, the European markets will be roiled by negative news about the enduring failure of governments to meet the Maastricht fiscal targets. In this light DM bonds appear safe against any EMU risk until late 1997. Investors who are absolutely risk-averse might prefer medium-term bonds up to 4-5 years maturity.

DOLLAR WEAKNESS IS FOR THE LONG TERM

Another question is the DM-dollar rate. According to conventional market thinking, the key determinants of dollar strength or weakness are growth and interest-rate differentials. With economic growth much stronger in the United States than in Europe or Japan, and U.S. interest rates also considerably higher, the dollar presently should be very strong, according to this model. Betting on it, the entire speculative world has gone long the dollar. After all, the model worked fabulously in 1982-85, even though the U.S. trade- and current-account deficits exploded.

What makes the difference this time is monetary policy. In the early 1980s, it was savagely tight. With rigorous reserve restraint, the Volcker Fed forced U.S. banks to fund their soaring domestic lending by drawing massively on the Euro market. The resulting banking inflows alone overfinanced the spiralling current-account deficit.

This time, the dollar's interest rate advantage has failed to work because the Fed's loose stance has been keeping U.S. banks flush with domestic liquidity, so much so in fact that since early 1995 they have even been net lenders to the Euro market. Future rate hikes, if not buttressed by true monetary tightening, will fail to prop up the dollar.

It is our long-held view that a U.S. current-account deficit of annually around $150 billion is much too big to be financed by foreign private capital. Taking the large U.S. capital outflows into account, it is a preposterous payments situation. Without the ever-higher dollar purchases of the Asian central banks, the dollar long ago would have collapsed. But with their own trade balances sharply deteriorating, their dollar purchases are drying up. In turn, the Fed never will apply the monetary stringency that would be needed to stop this rot of the currency.

CONCLUSIONS

The 15-year global bull market in equities is drawing to a close. The impetus from the prolonged, steep decline of interest rates is over, and earnings growth is at risk. In the long run, profits must grow in line with nominal GDP. In terms of GDP growth, the U.S. economy is strong. But to a large extent, it is the strength of a bubble economy.

In Europe, the issue of EMU is at a critical stage. Growing doubts about compliance with the key fiscal criteria work in favor of the DM and the Swiss franc.

THE RICHEBÄCHER LETTER

DR. KURT RICHEBÄCHER, Publisher and Editor.

Bill Montague, Associate Editor

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For now, Wall Street continues to celebrate the by-now routine achievements of successive record highs. But we find it noteworthy that these advances show declining strength and breadth, while pullbacks are becoming broader and more powerful. The dramatic narrowness of the market's recent advance is demonstrated clearly in the outperformance of the Dow and the S&P 500. Both have posted year-to-date gains of more than 9%, in contrast to the Nasdaq Composite's gain of 4.39% and the small-cap Russell 2000's gain of just 1%.

Meanwhile, yield spreads on corporate bonds and syndicated bank loans have shrunk to the vanishing point, not just in Europe but around the world. "Performance-driven" fixed-income managers have been chasing incrementally higher yields regardless of risk. But this process appears close to its limit, if only because risk premia already have virtually vanished.

Dollar bullishness is rampant again. There is talk of possible or probable overshooting, as in the 1982-85 period, when the dollar soared against a backdrop of a booming U.S. economy versus Eurosclerosis. In our view, this historical comparison is grossly misplaced. Economic growth and interest-rate differentials today are far narrower than they were in the early 1980s. Above all, the Fed then was very tight, while today's Fed is very loose. In the 1980s, tight money meant the soaring U.S. trade deficit was primarily financed through massive banking inflows. This time, overliquid U.S. banks are slashing their foreign liabilities. The dollar's current strength, in short, is driven by speculation, not fundamentals. It will reverse later this year.

Speculation about a delay in EMU once again is a talking point in the foreign-exchange markets. As always, such uncertainty tends to strengthen the DM.

Serious problems for the world economy and its financial system loom in the heavily indebted "miracle economies" of the Far East. Their race to industrialize using cheap labor has led to overbuilding in almost all sectors. The most pressing issue is the regionwide plunge in export growth, stemming from the slump in the global electronics industries.

The main risk factor for currency markets and global bond markets, however, will be the performance of the Japanese economy. The consensus sees nothing but economic weakness and ultra-cheap yen, owing to pending large tax hikes that will hit consumers hardest. But strength has been building rapidly in exports, business investment and residential construction. Unexpected Japanese economic strength late in the year could abruptly cut off the flow of cheap yen that has been fueling the global bubble. The dollar and U.S. bonds are particularly vulnerable.

Notice

Dr. Richebächer will be a guest speaker at a conference of the Committee for Monetary Research and Education, to be held at the Union Club of New York City the evening of Wednesday, April 9. Readers wishing to attend should contact the committee at 10004 Greenwood Court, Charlotte N.C. 28215. Telephone: (704) 598-3717.

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